Status of Competition

White Paper

The White Paper concluded that our pro-competitive regulatory decisions, coupled with advances in technology, have resulted in New York State being one of the most competitive markets for telecommunication services in the nation. That conclusion was based on a wide range of data, including our review of the availability of alternative platforms and the many options now available to customers, the changes in technology, and the loss of customers (i.e., telephone or access lines) by Verizon-New York.[45] Those results have also been experienced in comparable proportions by Frontier of Rochester, which the White Paper notes lost approximately 16% of its access lines between 2000 and 2004. The remaining 38 independent wireline companies in New York lost a combined 25,423 (3.4%) access lines over that same time period.[46] Most of these losses resulted from migrations to competitive carriers that relied on UNE-based competition and wireless substitution.[47] The introduction of intermodal telecommunications facilities and offerings of cable telephone likely now explain a sizeable portion of these losses. The White Paper cites Time Warner Cable's adding close to 15,000 new telephone customers per week and Cablevision adding approximately 7,000 per week as examples supporting this conclusion.[48]

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[45] In the second quarter of 2005, the company's access lines declined by an average of 87,000 lines per month (White Paper, p. 28). For the last quarter of 2005 the company lost an average of 72,000 lines per month. In January 2006, the company lost over 100,000 lines.

[46] White Paper, Appendix C.

[47] UNE refers to unbundled network elements which incumbent carriers like Verizon were required by the 1996 Telecommunications Act to lease to competitive carriers at favorable prices to facilitate local telephone competition. Today, one of the most significant mass market UNEs, namely the UNE-Platform, is no longer required based on the Federal Communications Commission's Triennial Review Remand Order issued in 2005.

[48] The figures for cable telephone subscription additions are national. State data is not publicly available.

The White Paper also refers to comments the Department of Public Service filed with the FCC in October 2004.[49] In those comments, the Department noted that over 50% of Verizon's wire centers offered customers access to alternative wireline offerings, and these wire centers represented 85% of Verizon New York's access lines.[50] The comments also included a competitive index designed to determine whether competitive companies were "impaired" in their ability to offer mass market local switching without reliance on Verizon's switches.[51] The Department concluded in those comments that the FCC should analyze impairment considering both intramodal and intermodal competition.[52]

The White Paper notes that there is now broad support for the conclusion that the New York telecommunications market is workably competitive. However, it also concludes that it may not be productive at this juncture to use the competitive index set forth in the 2004 FCC comments to develop granular findings about the extent and strength of competition.[53] (Parties had argued that the index measures the wrong factors, weights them incorrectly, and misstates the extent of competition.) The practical difficulties of applying such an index on a wire-center by wire-center basis and continuing or relaxing economic regulation on such a basis were also noted. According

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49 Comments of the New York State Department of Public Service in the Matter of Unbundled Access to Network Elements, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers, CC Docket No. 01-338 (filed October 4, 2004).

50 White Paper, p. 30, , In the Matter of Unbundled Access to Network Elements, Review of Section 251 Obligation of Incumbent Local Exchange Carriers, WC Docket No. 04-313, Comments of the New York State Department of Public Service.

51 "Impairment" is the standard for determining an incumbent LEC's obligation to give competitive LECs access to its switching services, and other network elements, as a UNE under the Telecommunications Act of 1996.

52 In the Matter of Unbundled Access to Network Elements, Review of Section 251 Obligation of Incumbent Local Exchange Carriers, WC Docket No. 04-313, Comments of the New York State Department of Public Service, p. 19.

53 White Paper, p. 30.

to the White Paper, broadly assessing the extent and strength of choice, judging competitive trends, and assessing competition as an overarching constraint on competitive behavior is a more productive approach, than examining competitive choice on a wire-center by wire-center basis.

Accordingly, the White Paper revised the index used in the 2004 FCC comments to produce a broader-based "competitive indicator."[54] Specifically, the White Paper concluded that the existence of three platforms, one traditional landline plus wireless[55] and broadband, in any market would indicate that the market is sufficiently competitive to constrain anti-competitive behavior of the market participants. Instead of relying on wire centers, it used FCC-based zip code data to determine broadband availability and FCC wireless antenna databases to determine wireless availability.[56]

While intermodal options are widely available, the White Paper recognizes there can be wire centers in an incumbent's territory that do not meet the three-platform test.[57] To determine whether prices are constrained in these non-competitive areas, the White Paper calculated whether a hypothetical 5% increase on a $50/month bill across the incumbent's territory would result in a net revenue gain (prices are not constrained) or a net revenue loss (price constraints are working). It found that with competitive platforms available to 93% of Verizon customers and 87% of Frontier of Rochester customers, it would not be possible under most elasticity assumptions for these utilities to raise rates across their service territories and thereby raise net revenues. The White Paper therefore concludes that Verizon's and Frontier's prices are being effectively constrained by the competitive markets, thereby justifying additional regulatory flexibility.

The White Paper recommends that this competitive indicator be used on a case-by-case basis to review the extent of competition and competitive pressures in each of the remaining incumbents territories to determine whether additional pricing flexibility

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[54] White Paper, Appendix E.

[55] To be considered a competitive alternative, a wireless carrier must not be affiliated with an incumbent.

[56] White Paper, Appendix E.

[57] The appropriate pricing for those areas is discussed below under "Pricing."

is warranted. It should also be used, it says, in a competitive review that should be completed within a year.

Responding to claims that cellular and VoIP services are not, or are not fully, substitutable for wireline (i.e., are not in competition with wireline), the White Paper states that the services need not be perfectly substitutable because only a small portion of the wireline customers need to consider them substitutable and exercise their option to change services in order to constrain wireline rates. In the White Paper's example, only 7% of wireline customers have to choose a different provider to render a hypothetical Verizon rate increase ineffective. It also notes that the provision of intermodal services are having profoundly negative effects on the incumbents' financial health, even if those services are not perfect substitutes for wireline.[58]

The White Paper also notes that competitive measurements such as the Herfindahl-Hirschman Index (HHI) or other examinations of competitors' market shares are a static analysis which fail to recognize the dynamic nature of the market. It argues that markets are contestable in most of the State because competitors can quickly enter and eliminate any supra-normal profit-seeking by the incumbents. Apart from the market shares of the competitors, the White Paper argues, the threat of imminent competition already serves as a significant constraint on incumbent behavior.

Parties' Comments

A number of the CLECs and incumbents applaud the White Paper's acknowledgement of the existence of significant and rapidly increasing competition in New York State, especially in the residential retail market. Those parties generally agreed with the White Paper's recommendations regarding increased regulatory flexibility. A number of the CLECs additionally argue that, while reduced regulation may be appropriate at the retail level, increased oversight of the wholesale market is essential given that the incumbent's do not offer their wholesale services in a fair and non-discriminatory manner.

58 The companies' financial positions are discussed below.

Parties representing consumers, on the other hand, while generally approving the goals and principles set forth in the White Paper, dispute the conclusion that a sufficiently robust competitive market exists today. Accordingly, these parties argue that any substantial change in the existing level of regulation should await a more detailed examination of the degree of competition. These parties also point to the recent mergers,[59] suggesting that such transactions raise additional concerns about the future competitiveness of the market.

More specifically, the DOL contends that the White Paper fails to respond to its initial, lengthy critique of Staff's competitive index, and believes the White Paper's competitive indicator is equally flawed. For example, the DOL argues that without sufficient evidence that intermodal services will displace the incumbents in the near future and without an adequate grounding in the economic analysis of customer demand elasticities, Staff's competitive indicator is seriously flawed. It says that the research shows that there is some substitution among services, but not so much as to permit the conclusion that wireless service actually constrains wireline price. "In fact," it goes on, "some evidence suggests that increased wireless usage actually stimulates demand for wireline service . . ."[60]

The DOL argues as well that the index weights assigned by the Department in its FCC comments do not reflect the various alternatives present in each market and that customers will respond differently to a particular alternative depending on their other options. The DOL argues that the index also needs to consider customer resistance to switching, and regional differences, and the possibility of market failure, consolidation or exit (as for example, through mergers).

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[59] Case 05-C-0237, Joint Petition of Verizon Inc. and MCI, Inc. for Merger Approval, Order Asserting Jurisdiction and Approving Merger Subject to Conditions (issued November 22, 2005), as revised in Errata Notice (November 28, 2005), and Case 05-C-0242, Joint Petition of SBC Communications Inc., AT&T Corporation, together with its Certified New York Subsidiaries, for Approval of Merger, Order Approving Merger (issued September 21, 2005).

[60] The DOL's comments on the Order Initiating Proceeding, Appendix, p. 3 (citing studies).

Others argue that Staff's approach in the Verizon and SBC merger cases used a more rigorous application of market power tests than was used in this proceeding, also suggesting that a more detailed review of the market should be or must be undertaken prior to making any final decisions on the relaxation of regulations or the deregulation of any carrier.

The evidentiary underpinning of Staff's proposal is exceedingly thin, according to the Assembly Standing Committee. If there is a rationale for the proposed rate increases for Verizon and Frontier of Rochester, the Committee contends that it is not reflected in the record.

CPB states that the White Paper overestimates the extent of competition by assuming that the mere availability of intermodal alternatives will ensure high quality services and just and reasonable prices and by incorrectly treating often expensive bundles of related telecommunication services as a competitor to stand-alone telephony. Staff has no data, according to the CPB, regarding the extent to which New Yorkers substitute intermodal services for their primary wireline. It says that the availability of intermodal alternatives does not create a competitive market.

CPB concludes that a detailed and accurate measure of the extent of actual competition should be made before implementing any regulatory changes.

The Farm Bureau disagrees with the White Paper's conclusion that true competition exists in many areas of the State, contending that in rural areas there is a lack of adequate infrastructure to support high speed internet access.

Time Warner Telecom argues that there is an inadequate evidentiary record upon which to determine the extent of competition in New York. It agrees with the DOL's comments in that regard and suggests that the Commission undertake a more detailed assessment of the actual state of the markets. It remains to be seen, according to Time Warner Telecom, whether intermodal entrants can garner a sufficient market share to constrain the exercise of market power. Time Warner agrees with the need to undertake a further competitive review,[61] but it argues that such a review should be undertaken before any additional pricing flexibility is granted.

Cablevision submits information challenging the Staff competitive analysis by arguing that there cannot be a market as robust as described because Verizon has raised its basic service prices by more than 13% in the past year.[62] It also argues that the White Paper failed to consider the impact of the loss of UNE-P[63] competition or the impact on competitive markets of the recent merger approvals. Cablevision therefore concludes that the market assessment in the White Paper lacks rigor and a theoretical foundation, is untested, and is methodologically flawed. In Cablevision's view, the competitive market conclusions are no more than unsubstantiated suppositions about how the market might evolve. The presence or potential presence of competitors, according to Cablevision, is not the same as the presence of actual competition.

Cablevision also challenges Staff's assumption that VoIP service is the equivalent[64] of wireline service and is a more important form of competition than CLECs' services. As of the end of 2004, Cablevision argues, in New York State the CLECs had 3.6 million lines and wireless had 10.8 million lines, while the VoIP lines and growth rates yield at best hundreds of thousands of VoIP subscribers. To treat VoIP as an equal competitor with wireless and the CLECs misstates current market realities, according to Cablevision, and leads the White Paper to overestimate the amount of competition.

Cablevision also suggests that Verizon's service quality has not been disciplined by competition as evidenced by the Commission's suspension of Verizon's pricing flexibility under the VIP and the Commission proceeding regarding an independent audit of Verizon's service quality. It cites as support Verizon's 2004 Annual

[61] Time Warner Telecom comments, p. 3, citing White Paper, p. 49.

[62] Cablevision's comments, p. 2, citing Verizon tariff leaves.

[63] UNE-P refers to the unbundled network element platform and refers to the combination of unbundled elements that allow a competitor to provide full service.

[64] Cablevision markets its Optimum Voice (its VoIP product) as "high-quality home phone service." (see www.optimumvoice.com)

Report to stockholders, indicating that approximately $900 million of capital spending was reallocated away from "traditional products to growth products."[65]

Cablevision and others also attack the competitive indicator proposed in the White Paper[66] contending that it is an unnecessary invention. According to these parties, more traditional measures of market power are available and should be relied upon. Staff's measure of competitiveness continues to significantly overstate the level of competition posed by wireless and VoIP services, according to these parties. Because the indicator attempts to quantify competition by the number of potential competitors rather than by the market concentration of actual suppliers, they say it overstates the extent of market competition and deregulating markets based on such measures would not be in the public interest.

Cablevision also argues that neither wireless nor VoIP services are in the same market (i.e., are substitutable) with the services offered by the incumbents. If these are not substitutable products, Cablevision argues, there is no true competitive market.

The Department of Defense also disagrees with the White Paper's assertion that competition has constrained the pricing flexibility of incumbents, as an example, the fact that a small business line is more expensive than a residential line, despite the fact that the costs to serve those customers are virtually identical. The Department of Defense acknowledges a slight reduction in the incumbents' market power due to recent wireline losses, but concludes that the reduction is not sufficient to constrain the incumbents' facilities-based competition, it concludes, the incumbent wireline and cable companies will maintain an effective duopoly.

CompTel argues that not all market segments have available true local competition. In particular, it contends that the business marketplace does not generally accept wireless or VoIP/cable telephony as acceptable substitutes for wireline service. Accordingly, it argues that there is no intermodal competition for business customers.

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65 Cablevision comments, p. 13, quoting Verizon Communications 2004 Annual Report, p. 14.

66 Cablevision comments, pp. 18-26, discussing White Paper, pp. 28-34.

CompTel joins the criticisms of the DOL and CPB of the White Paper's competition indicator. It also concludes that the regulatory policies and technological advances of the past few years have not harmed Verizon's financial position.

The Joint CLECs emphasize the fact that the White Paper primarily addressed residential consumers, noting that the conclusions would not be the same for the small to medium-sized business market.

Frontier of Rochester suggests that Staff's competitive indicator understates the extent of actual competition and needs to be adjusted to reflect the actual level of wireless competition. Staff's analysis only considers cell service as available if the cell tower is located in the wire center, but Frontier argues that the coverage of such a tower is much larger than a wire center and a single tower could be providing cell service in more than one wire center. Staff's approach, according to Frontier of Rochester, results in a significant underestimate of competition in the independent company territories. also requests that a competitive market be found with the existence of a cable company offering voice or broadband services without the need for a wireless platform. In other words, Frontier suggests that only one other alternative platform is needed to determine an area competitive. It further objects to the White Paper's failure to consider Verizon wireless as a competitor in Verizon's wireline territory. According to Frontier, all of these factors underestimate the extent of cellular competition.

Frontier also argues that there is no reason for the distinction the White Paper makes between providing Verizon and Frontier of Rochester with increased pricing flexibility and not providing the same relief for the remaining incumbents. Most or all of the remaining incumbents, according to Frontier of Rochester, face the same or nearly equal competition that Frontier and Verizon face, especially if the cellular adjustments to the Staff competitive indicator are incorporated. It accordingly contends that all incumbents who can meet the White Paper's standards, as adjusted to reflect the true impact of wireless, be provided the same flexibility the White Paper recommends for Verizon and Frontier.

NYSTA contends that a natural monopoly in the wireline market no longer exists. It, therefore, concludes that no competitive indicator is necessary. It also expresses its concern that line losses and loss of access minutes by the smaller incumbents will place them in serious financial difficulty, and it contends that those incumbents should be accorded at least the pricing flexibility and increased revenues contemplated for Verizon and Frontier of Rochester.

Verizon generally supports the White Paper's conclusion that the market is sufficiently developed to discipline prices. It also points to alleged errors in the White Paper's competitive indicator, the effect of which is to render Staff's analysis overly conservative. While it believes Staff's competitive indicator is a workable and useful tool, Verizon points to its failure to consider Verizon wireless as a competitor to Verizon-NY, thereby rendering the indicator's measure of competition unduly conservative. Verizon, like Frontier, also raises the point that a single cell tower can serve more than one wire center, making the indicator overly conservative. It also notes that multiple wireless carriers can co-locate on a single tower, but the indicator considers the tower as a single competitive provider rather than as multiple providers. Finally, Verizon notes that the data Staff used to construct the competitive indicator were for 2004 and therefore do not fully reflect market dynamics and the very rapid growth of cellular and VoIP services in the past year.

Verizon also challenges the assertions made by some of the parties that wireless and VoIP competition with wireline are not robust. It notes the discounted package offerings it has tariffed in recent months,[67] contending that they reflect the potent competitive threat offered by VoIP-based products. Challenging the arguments by CLECs and others regarding the competitiveness of the small and mid-size business customer market, Verizon says that small businesses have access to broadband (and,

[67] Case 05-C-1303, Petition of Cablevision Systems to Reject or Suspend and Investigate Verizon's Proposed Tariff Amendment to Establish a Regional Value and Regional Essential Plan, Order Denying Petitions Requesting Suspension of and Hearing on Tariff Filings (issued December 6, 2005).

therefore, access to VoIP-based services) and that cable companies and VoIP providers offer customized solutions for large business customers.[68]

Discussion

Our experience and the record in this proceeding reveal, as noted above, that competition in New York's retail telecommunications markets has evolved dramatically over just the past few years, especially in the residential portion of the mass market. Many more people now carry mobile devices to maintain constantly available telecommunications capabilities, and rising numbers of consumers are abandoning wireline services altogether. High-speed internet access services, offered by multiple providers, enable e-mail, instant messaging, and VoIP services that expand consumers' telecommunications options, competing directly and indirectly with traditional telephone services. Every month thousands of customers in New York switch from their incumbent local exchange service providers to intermodal competitors to obtain savings, innovative services, and other value added offerings. The Staff White Paper correctly observed that "Plain Old Telephone Service (POTS) won't mean a wireline telephone much longer."[69]

The vast majority of New Yorkers now have the choice of obtaining voice services from different providers via alternative platforms.[70] Staff estimated that 90% of New Yorkers have the choice of at least two intermodal alternatives to the incumbents'

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[68] Verizon's Comments, p. 22.

[69] White Paper, p. 3.

[70] Analysis of data compiled from the Numbering Resource Utilization/Forecast (NRUF) 502 Reports, filed semi-annually with the FCC and the North American Numbering Plan Administrator, further illustrates this trend. Numbers assigned to carriers in New York have increased 12% over the last three years (2002 – 2005). There has been significant growth in numbers assigned to competitive carriers and wireless providers, 46.7% and 47.2%, respectively, while the numbers assigned to incumbents have decreased by 7%. The increasing popularity of VoIP is one contributing factor to the increase in numbering resources for competitive carriers, as the VoIP providers obtain numbers through partnering with competitive carriers (i.e., Time Warner Cable partners with Sprint and Cablevision partners Cablevision Lightpath).

wireline networks.[71] CPB argues that Staff has no data regarding the extent to which New Yorkers substitute intermodal services for their primary wireline, but it misses the point. It is clear, even from advertisements aimed at the general public that cable, wireless and IP service companies are competing with wireline companies to provide telecommunication services. CPB's emphasis on historical data does not capture the prospective environment upon which competitors' business plans must be made. Establishing our policy for the future based on that history is unwise.

Based on the availability of these platforms, customers could choose a number of different service providers currently marketing services in New York. In general, these services fall into three categories: facilities-based digital phone service (i.e., cable phone), application based phone service (e.g., Vonage) and wireless service. We find that these services are widely available in New York and that from the perspective of customer demand they are sufficiently close substitutes for traditional wireline local service.[72] Cable companies (Cablevision and Time Warner) are actively

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[71] Our responsibility is to ensure just and reasonable rates for all New Yorkers and we will continue to do so even for the minority that does not have competitive choice. As explained below in the pricing section, even those customers not located in an area where there is vibrant competition will enjoy the benefits of the New York markets because incumbents will be constrained from increasing prices in noncompetitive areas.

[72] We note that the FCC also recently concluded that facilities-based digital phone and wireless are sufficiently close substitutes for wireline local service. In the Matter of Verizon Communications Inc. and MCI, Inc. Applications for Approval of Transfer of Control, WC Docket No 05-75, Memorandum Opinion and Order, 20 FCC Rcd 18433 (2005) ¶¶ 83-91 (Verizon/MCI Merger Order). Although the FCC found the record inconclusive regarding application based VOIP services (i.e., "over-the-top" VOIP), in part because customers must separately obtain broadband access, it noted that some proportion of mass market consumers may view these services as substitutes for wireline local service. Id. at ¶ 89.

marketing a digital phone service to a large number of customers in New York.[73] Their offerings provide E911 connectivity similar to traditional wireline services and is priced between $30 and $49 per month.[74] This is comparable to Verizon's Freedom Value package ($29.95 downstate and $34.95 upstate) and its Freedom Essentials package ($34.95 downstate and $39.95 upstate)[75] In our judgment, consumers view these offerings as close substitutes to wireline local service.

Regarding application-based VoIP services, we recognize that they have different service characteristics, like self installation, and may not be viewed widely as close substitutes. But given that in excess of 35% of New Yorkers already subscribe to some kind of high speed broadband service,[76] these customers could subscribe to an application based VoIP service being offered by a number of providers such as Vonage without an additional subscription to broadband. Moreover, the FCC recently required that these interconnected VoIP services provide E911 capability similar to that offered by traditional carriers.[77] Vonage, for example, offers an unlimited calling plan for $24.99 per month.[78] In view of the potential significant cost savings, and the FCC's requirement

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[73] Time Warner Cable's December 5, 2005 press release reads: "By the end of 2004, the Company had successfully rolled out Digital Phone to all of its divisions, across 27 states. Having achieved its unprecedented goal of fully deploying phone service within 18 months, Time Warner Cable has turned its focus to rapidly signing up new phone customers." Cablevision's website states that "Optimum Voice is currently available to Optimum Online customers in most areas of New York, New Jersey and Connecticut for one low, flat rate of $34.95 per month without any additional monthly charges or fees."

[74] Cablevision Optimum voice service costs $29 per month; Time Warner's digital plan costs $39 when bundled or $49 as a stand alone service.

[75] Both of these packages (as well as Verizon's Regional Value and Regional Essentials packages) reflect significant price decreases from prior similarly packaged services. As one example, Verizon's Freedom Essentials Package was previously priced at $59.95 just six months ago.

[76] FCC Report on High-Speed Services for Internet Access: Status as of December 2004.

[77] E911 Requirements for IP-Enabled Services, WC Docket No. 04-36, First Report and Order and Notice of Proposed Rulemaking, 20 FCC Rcd 10245 (2005).

[78] www.vonage.com

that such providers offer E911, we believe these services can also serve as a close substitute for traditional wireline service for a significant number of New York consumers.

Subscriptions to wireless services have increased dramatically in the past few years. Although the White Paper recognized that not all customers will view wireless service as a complete substitute for traditional wireline service, we agree with the White Paper that a growing number of customers are willing and able to consider wireless as a close substitute for wireline service.[79] A recent survey reported that about 9.4% of US wireless subscribers already use a wireless phone as their primary phone.[80]

Many consumers are taking advantage of these options and are reaping the benefits of technology and competition;[81] as a result, former monopoly providers are losing customers, lines, usage, and revenues.

Since the White Paper was issued, the incumbents have continued to lose access lines. Through 2005, the twelve-month rolling average of Verizon's monthly line losses exceed 80,000, a rate of almost 1% of its access lines each month or approximately 12% annually. In January 2006, Verizon lost more than 100,000 access lines. Frontier of Rochester lost almost 38,000 lines in 2005, approximately 8 % of its total lines. These continuing and increasing losses do not suggest a slowing of the residential, intermodal

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[79] Morrisville State College in New York eliminated land lines in dorm rooms and handed out cell phones to each of its students living in its residence hall. Colleges Catch Phone Wave, USA Today, October 29, 2003.

[80] In-Stat, "Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution." (October 2005). In its recent Verizon/MCI Merger Order the FCC found that approximately 6% of households have chosen to rely on wireless services for all of their communications needs. Verizon/MCI Merger Order, supra ¶ 91.

[81] Between December 2004 and December 2005, Cablevision's and Time Warner's phone subscriber base had significant growth. Cablevision's phone subscriber base grew by 457,000 from 282,000 to 739,000. (Cablevision Systems Corporation Reports 4th Quarter 2004 and 4th Quarter 2005 Results.) Similarly, Time Warner's phone subscriber base grew by 880,000 from 220,000 to 1.1 million customers. (Time Warner Inc. Reports 4th Quarter 2004 and 4th Quarter 2005 Results.) Vonage's February 8, 2006 S-1 Filing with the SEC states: "We are a leading provider of broadband telephone services with over 1.4 million subscriber lines as of February 8, 2006."

competitive market, as some parties have suggested. If anything, technological advances and the development of new products and features suggest that intermodal competition with landline service will only increase at an accelerating pace in the next few years.

Verizon and Frontier of Rochester in particular are experiencing real losses in market share and revenues as a result of this dynamic market competition. Given the substantial network investments of facilities-based competitors, we expect that they will tenaciously expand and defend their market shares. It is therefore clear that the various forms of intermodal competition are undermining the incumbents' ability to set rates in excess of relevant costs.[82]

Although the other incumbents are also dealing with the effects of growing intermodal competition as evidenced by decreasing access minutes and access lines,[83] it is not clear that all incumbents face sufficient direct competition to serve as an adequate check on their exercise of market power. The White Paper notes[84] that the other incumbent telephone companies in New York have also lost lines. Frontier of Rochester is reported to have lost 16% of its lines from 2000 to 2004, while the remaining 38 incumbents have lost approximately 3.4% of their access lines over that same timeframe (2000-2004).[85] While there may be individual companies that have suffered concomitant competitive revenue losses comparable to Verizon and Frontier of Rochester, that fact cannot be determined from this record. Staff's White Paper notes a significant variance in line loss across the independents, with some companies actually reporting an increase in access lines over the 2000 to 2004 timeframe.[86] Accordingly,

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82 The financial impact of this competition is discussed in the following section on pricing flexibility.

83 Rural Telephone Companies, Initial Comments, Exhibit 5.

84 White Paper, p. 28.

85 Taking Frontier together with the remaining 38 independents, the white paper reports that these 39 companies have lost 8.7% of their access lines, about one-third the losses of Verizon (25%).

86 Staff White Paper, Appendix C.

we will examine the relative competitive positions of these incumbents on a case-by-case basis to determine if increased pricing flexibility or other regulatory flexibility is warranted. Whenever an incumbent can demonstrate that its prices are constrained by competition, we will consider granting pricing and other flexibility.

A number of parties have challenged the basis of our finding that a robust competitive market exists today sufficient to constrain the incumbents' prices. Some argue that the recent Verizon and AT&T mergers raise serious concerns regarding the future competitiveness of the market, and others note that more traditional market power tests, such as HHI,[87] would show the incumbents with considerable market power. Others contend that the mere existence of competitors does not mean that there is a robust competitive market, especially in rural or less affluent areas. Further, CompTel argues that not all markets have intermodal options, specifically mentioning business customers. Finally, Cablevision argues that competition has not been effective in ensuring Verizon's service quality.

Arguments that the degree of competition is exaggerated or is not supported by the facts are not correct. The degree of competition is clearly reflected in the continuing incumbent line losses, the current availability and rapid expansion of wireless and VoIP services, and the competition-driven revenue losses, as well as declines in earnings and, in some instances, losses. While the recent Verizon/MCI and SBC/AT&T mergers (as well as FCC rulings[88]) may reduce UNE-based CLEC competition, those mergers will have little, if any, negative impact on intermodal retail competition and may spur its growth as UNE-based options become less available. In response to CompTel's argument, we note that VoIP products, initially introduced and focused on the residential market, are being marketed to business customers and Vonage markets to business

[87] The Herfindahl-Hirschman Index (HHI), the sum of the squares of the market shares of each firm in a market, is a measure of how concentrated a market is.

[88] TRRO.

customers as well.[89] Finally, Cablevision is correct in noting the Commission's close monitoring of service quality as reflected in both our suspension of Verizon NY's pricing flexibility and our directing an independent audit of Verizon retail service quality. There are several different indices that we review to gauge service quality. With one exception, Verizon-NY's service quality performance has generally met or exceeded our standards. (For the one exception, the Out of Service Greater than 24 Hours metric, we expect Staff to continue to engage the Company on its improving this performance.) We are confident that competitive pressures will provide Verizon sufficient incentives to improve this metric. Importantly, nothing in this order removes our continued rigorous oversight of service quality, and we continue to monitor and ensure adequate service quality pursuant to the Public Service Law.

We also conclude that, in view of the dynamic nature of the telecommunications market, Staff's competitive indicator and observations of market trends provide a more meaningful picture of the state of the intermodal competitive market than does the simple look at recent actual market shares that is embodied in the HHI. The HHI is a proper analytical tool, but it is just the starting point in any assessment of the competitiveness of a market. As is discussed in the Merger Guidelines of the United States Department of Justice and Federal Trade Commission, other factors, especially those associated with entry by competitors, can overcome a market power presumption that might otherwise be indicated by a simple look at the HHI.[90] While we are aware of the high HHI for wireline mass market voice calling in New York that one can derive from recent actual market shares, the evidence is clear that other factors, including entry by new competitors, play a more crucial role than starting-point HHIs in any analysis of this market. In fact, Staff's competitive indicator focuses on exactly this – the extent of the presence in New York of the newer modes of entry.

[89] For example, Dell Computer Small and Medium Business Magazine for February 2006 contains an ad for Vonage ("Switch to Vonage for Your Small Business"). Likewise Cablevision provides Optimum Voice to small businesses.

[90] Horizontal Merger Guidelines, United States Department of Justice and the Federal Trade Commission (issued April 2, 1992 and revised April 8, 1997), http://www.usdoj.gov.

Deviation from reliance on HHIs is appropriate here. The broadly defined telecommunications market is expanding at an unparalleled rate, and change is constant. The adoption of internet protocol and the advancement of computer technology cause new entrants to experience lower costs. This allows intermodal competitors rapid and inexpensive entry into the voice market and permits them to contest quickly any monopoly-based pricing of these services by the incumbent. The market is continually expanding, both in scale and scope, causing an ever changing measurement of the size (or total demand) in the market. Static measures of market share such as HHI's do not reflect this reality. Accordingly, measurements of competitor's historic market shares as considered in HHI calculations are of limited significance and provide limited guidance in determining the ability of the intermodal competitive market to constrain monopoly behavior. This market, suitably monitored, can be considered adequately competitive to support the actions we are taking.

We are also not convinced that our actions should be restrained by a concern that the telephone market is or is becoming a duopoly. There are three, not two, major pathways into the customer's premises: traditional wire, wireless, and broadband via cable. Furthermore, within each pathway there are multiple providers of telephone services, especially so for providers of telephone service over broadband. Third, as we look to the future, it would be unwise to assume a duopoly. Future modes, including those we know of such as broadband over power line (BPL) and those we cannot yet conceive of, may well emerge.

And, in any event, concern about duopoly is not something that should unduly constrain us in the decisions we take today. (Even if the market were a duopoly, the goal of establishing just reasonable rates could be well served by our actions, because the new entrants are able to enter at such low costs.) A new company, even if there were only one, can place significant competitive pressure on the incumbent – enough to constrain the incumbent's ability to raise price – if the new company's cost of providing the service is dramatically lower than the incumbent's existing price. Finally, we reserve the right to take the appropriate action in the event that abuses occur or seem imminent.

Nor are we convinced that the lack of complete substitutability of intermodal services for wireline services renders the White Paper's estimate of the extent of competition unreliable. As Staff notes,[91] only a small proportion of consumers need to react to an incumbent's price increases to render futile the incumbent's efforts to raise revenues. Telecommunication services are purchased both as a substitute for and a complement to other telecommunications services, and, given the uniformity rule discussed below[92], the issue of complete substitutability is of lesser consequence. Similarly, while the mere existence of potential competitors does not create a market, given the facts here, actual and potential competitors are constraining the ability of incumbents to exercise market power in setting prices. Finally, we agree with the White Paper's conclusion that bundled telecommunication services, VoIP, and wireless are all in competition with unbundled wireline services, as the incumbent's continuing loss of lines and access minutes strongly suggests.

The data we now have fully support our conclusion that Verizon's and Frontier of Rochester's prices are being constrained by actual and potential intermodal competitors.[93] Cablevision's argument that a Verizon-NY increase in basic rates of 13% in the past year undermines Verizon NY's statements on its inability to profitabty run its wireline business is flawed. Verizon's last rate increase in basic rates was in March 2003, as part of the Verizon Incentive Plan. That increase, and the increases allowed here are more an indication of the need to better align basic rates with underlying costs than the absence of competition for non-basic services. Verizon continues to price local exchange

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[91] White Paper, p. 34.

[92] See Pricing, infra. The uniformity rule – by requiring one price across a service territory or a part thereof – insures that customers in an area that may not be competitive get the benefit of a competitive price.

[93] "Contestable market theory indicates that dominant providers will refrain from monopoly pricing and cost cutting on service quality if competitors can quickly enter and take away a significant share of the incumbent's customers in response to such supra normal profit seeking behaviors." (White Paper, p. 40).

service competitively.[94] Finally, individual reviews of the franchise areas of the independent local exchange carriers is required to determine whether additional pricing flexibility is appropriate for the balance of the incumbents, and we will grant them flexibility if they are able to make an adequate showing.

Turning to Staff's competitive indicator, we recognize that additional adjustments and more refined assumptions can always improve results, but we are satisfied that Staff took a conservative approach, which might be more accurately characterized as underestimating the extent of competition. For example, the indicator does not consider the extent of UNE-based CLEC competition (currently millions of lines), fails to consider Verizon Wireless as a competitor to wireline, and does not consider that multiple providers can be co-located on the same tower. Even assuming arguendo that the criticisms of the White Paper's competitive indicator have merit, the failure of the indicator to consider the above factors suggest that it under-estimates rather than over-estimates the level of competition. Accordingly, we find the Staff indicator an appropriately cautious way to proceed and see no need for further adjustments.

We will also use the indicator, subject to future refinements as appropriate, when we reevaluate the competitiveness of the market. Among the other things we will consider in that review are:

- service quality results in competitive areas as compared in noncompetitive areas;
- price changes that have occurred;
- entry and exit of competitors, and,
- additional line and minutes of use losses.

We direct Staff to perform this evaluation and report back to us in twelve months. We expect that it will find the competitive indicator a useful tool in that endeavor and, if it does, it should use it.

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[94] Case 05-C-1303, Petition of Cablevision Systems Corporation Concerning Verizon's Regional Value Plan and Regional Essentials Plan, Order Denying Petitions Requesting Suspension of and Hearing On Tariff Filings (issued December 6, 2005).

In conclusion, we find that the telecommunications market in New York State is, in aggregate, adequately competitive.[95] Perfect competition, which is the ideal, is not needed; the market need only be adequately competitive. Given the inefficiencies inherent in economic regulation, a market need not be perfect, or even near-perfect, to produce better outcomes for consumers than traditional regulation, given the well-documented inefficiencies of the latter, and its shortcomings in an increasingly competitive market. Therefore, despite the lack of the ideal of a perfectly competitive telecommunications market in New York, we find that the forces of competition are sufficiently strong, both now and for the foreseeable future, to easily be considered an adequately competitive market. Alternative facilities-based platforms and viable substitute services are available in the market sufficient to constrain most residential prices such that we can and should rely more heavily on market forces to set prices. The approach we outline in this Policy Statement and Order – discussed below in the Pricing section – is the best approach for setting just and reasonable rates in this environment.

[95] The qualifier "in aggregate" is important. While there may well be geographic pockets in which intermodal competition has not yet fully emerged, the aggregate nature of our pricing rule (see the uniformity requirement discussed below in the Pricing section), creates an aggregate setting for the incumbent's pricing decisions, and therefore, protects consumers in such pockets.

Pricing

White Paper

Where companies face significant competition, Staff argues, a new regulatory approach is warranted. In such markets, less economic regulation is needed, as price abuses are constrained by competition. The White Paper concludes that firms become price takers under such circumstances and no longer have the ability to ensure that prudently incurred costs will be recovered.

The White Paper posits that regulated rates of return have become less relevant, and traditional regulatory accounting, especially the establishment of regulatory assets, is no longer viable. Reviewing the actions we have taken under the 1995 Performance Regulatory Plan (PRP)[96] and under the Verizon Incentive Plan (VIP),[97] the White Paper echoes our 2003 statement that the PRP was the first step away from traditional cost-based regulation and the VIP was the second step.[98] In this proceeding we are taking a third step.

Because competitive forces are constraining prices and undermining the incumbents' ability to charge revenues sufficient to cover costs, the White Paper asserts that the incumbents should be allowed additional flexibility to price and provide services for which there is a public demand. While competition may not be uniform statewide, the interests of all citizens will nevertheless be protected by the provision of a fully regulated basic service rate, according to the recommendations in the White Paper. This dual approach -- providing the incumbents pricing flexibility and reexamining the need for other non-economic regulation, together with providing the public a fully regulated rate for basic service - - results in a reasonable balance between the interests of the regulated carriers and the interests of the public.

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96 PRP order, supra.

97 In both cases, the Commission balanced customer and investor interests in establishing a more flexible regulatory atmosphere.

98 Case 02-C-0959, Petition filed by Verizon, New York, Inc. for Approval, Pursuant to PSL Section 113(2) of a Proposed Allocation of a Tax Refund from the County of Nassau, Order Allocating Property Tax Refund (issued March 12, 2003) p. 4.

The White Paper recommends that a basic service offering at a regulated, tariff rate be maintained.[99] Staff proposes that this basic service be flexibly priced up to a statewide uniform maximum price, noting that both competitive offerings and incumbent bundled offerings are often priced at uniform rates across service territories. All incumbents would be permitted to increase their current basic service rates up to this cap over a three year period with annual increases limited to $5.00 per month.[100]

In calculating the proposed state-wide rate cap, the White Paper begins with a package rate that Verizon introduced in New York City in 2003. In Manhattan, Queens, Brooklyn and the Bronx, the only type of tariffed local service offered by Verizon was "message rate" service. Under message rate service, a customer pays a basic access line charge of $8.61 per month and then pays 9 cents per call for local calls; there was no "flat rate service" that includes unlimited local calling. However, in 2003, in response to the competitive pressure of other carriers' offering an array of unlimited call packages, Verizon introduced a single price for unlimited calls of $16.34 to be paid in addition to the $8.61 basic access line charge. The combined total of $24.95 thus represents an "all-in" local basic service rate for the most competitive areas in the state.

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99 The White Paper defines that service as "a single, residential line without features, offered as a stand-alone service universally throughout all exchanges. The service would include flat rate local calling where the local calling area is no less than the current area, including extended area service adjacencies, touch tone, the ability to place and receive calls to and from any PSTN telephone number, long distance equal access, full backup power for the minimum hours consistent with what is currently required of the incumbent, full 911/E911, CALEA and other public safety compliance, full call signaling compliance, compliance with applicable industry standards for sound quality and availability, and the consumer protections provided by Commission regulations." (White Paper, p. 41.)

100 The increase would be to the monthly bill, which could increase by no more than that amount each year (so that the largest annual total increase a customer could pay would be $60). In response to a CPB inquiry, Staff subsequently clarified that message rate basic service could also be raised to the statewide uniform price over a three year period with the message rate charges being reduced as the basic rate is increased. Staff assumed that when the message rate service reached the statewide cap, message rate charges and message rate basic service would be eliminated. In a similar manner, Staff expected that rate groups will also be eliminated as basic service rates are moved to the rate cap.

The White Paper selected this $24.95 as an appropriate state-wide cap for basic local service. It concludes that $24.95 is a just and reasonable rate because Verizon's underlying offering was priced in response to competitive market pressures and because each of the components of the rate had previously been determined to be just and reasonable.

Using forward-looking cost studies, the White Paper also concludes that the cost of serving metropolitan areas is less than the cost of serving less densely populated areas of the state. It therefore finds that a competitively constrained rate in a metropolitan region (i.e., the $24.95 rate) would be just and reasonable in other areas of the state where the utilities' underlying costs are even higher.

Verizon's recently filed tariff offering basic service plus three features for $17.00 downstate and $22.00 upstate was also addressed by the White Paper. It declined to recommend the adoption of those prices as set by the competitive market because the service was only recently offered, and Staff was unsure how long the new offering would remain available. The White Paper concluded that these prices should not be used without more extensive experience. It further noted that if market forces push competitive prices below the $24.95 ceiling, competition has done its job and consumers will reap the advantages.

Addressing the range of current basic service offerings priced lower than $24.95, the White Paper explains that those rates stem from legacy regulation. Under that system, local rates were subsidized with higher margins from previously more lucrative although now more competitive markets. Such an approach is no longer workable, and, as a general matter, rates must be better aligned with costs. Allowing the incumbents to move to a uniform, statewide, basic service rate of $24.95 will help accomplish that goal, according to the White Paper.

Turning to the incumbents other than Verizon and Frontier of Rochester, the White Paper again notes significant line losses, albeit less than those for Verizon and Frontier of Rochester. In addition, the White Paper notes a significant loss of access minutes from these carriers, and both losses result in reduced revenues for the incumbents. For these carriers, the White Paper proposes the same $24.95 basic service rate cap and similarly allows local basic service rates to increase at "the higher of $5.00 per access line per month or 2.5% up to the rate cap of the basic service offering...."[101]

The White Paper indicates that the incumbents would be required to charge customers a uniform basic rate throughout their service territories, thereby precluding discriminatory pricing. To address in part the loss of revenues from access minutes, the White Paper also recommends that the base rate increase for these other independent incumbents be implemented together with an offsetting reduction to intrastate access charges to bring those charges more in line with each company's interstate access rates and related costs. Any further earnings deficiencies of these incumbents would, according to the White Paper, be dealt with in the context of a traditional rate case. The White Paper states that adopting such an approach will move the independent incumbents closer to the access rate structure of Verizon and Frontier, will ease the financial pressures due to the loss of access minutes, and will move base rates closer to costs.

Turning to non-basic services, the White Paper recommends that Verizon and Frontier of Rochester have full pricing flexibility for all services other than basic service. Under the White Paper's approach, uniform prices on a service territory-wide basis would be required for non-basic offerings, and Verizon and Frontier of Rochester would be provided the ability to rapidly change those rates to any desired level in response to competitive pressures. The basis for the White Paper's uniform pricing recommendation is to provide just and reasonable rates for non-basic offerings by requiring offerings to be uniformly priced in both competitive and noncompetitive areas.[102] The theory is that the incumbents will need to price services competitively in areas where they are subject to competition, and uniformity of such a competitive pricing structure will carry over to and protect consumers in noncompetitive areas. As explained by Staff, "even when not all customers have three platforms, if a sizeable majority of them do, the aggregate demand facing the incumbent that serves them can be sufficiently

[101] White Paper, p. 46.

[102] The White Paper also sought comments on how to resolve the problem of allowing price discounts (desirable in the market), which it says appears to be prohibited by the Public Service Law (PSL) Section 92(5).

price elastic to constrain the incumbent's ability to profitably raise prices."[103] Given the extent of competition for non-basic services, the White Paper concludes that there will be no need to review prices in advance.

The flexibility recommended for Verizon and Frontier of Rochester is not recommended for the remaining independent incumbents because it remains unclear whether competition has impacted each of the independent companies to the same extent it has effected Verizon and Frontier of Rochester. The White Paper recommends the use of Staff's competitive indicator to review the level of competition experienced in each of the independent companies' areas on a case-by-case basis. Based on that review, the White Paper recommends that each company be given the opportunity to demonstrate what additional flexibility or increased rates are needed to meet the level of competition they are experiencing.

The White Paper also notes the importance of continuing to monitor incumbent behaviors and the extent of competition. As the market continues to grow and mature, additional regulatory requirements may need to be eliminated. It accordingly recommends that a more granular competitive review be conducted within a year of the conclusion of this proceeding with the results of that review used to further streamline regulatory requirements. The Commission should move quickly, according to the White Paper, to reduce or eliminate any additional economic regulation imposed on dominant traditional carriers and to make those regulations more consistent with the requirements for non-dominant carriers, when appropriate.

Finally, the White Paper notes that there are various categories of reporting requirements regarding economic regulation which should be reviewed in a separate rulemaking. More specifically, the White Paper discusses streamlining merger or sale conditions and expresses the opinion that the process of approving acquisitions for small telephone companies can be improved. It also suggests that it would be reasonable to consider financial incentives to encourage the acquisition of small telephone companies in a manner similar to the policy we instituted for small water companies.

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[103] White Paper, p. 33.

Parties Comments

The DOL, Dr. Bronner, Cablevision, CTANY, the Assembly Standing Committee, CWA, and CPB argue that the proposed $24.95 rate cap for basic service is not supported by the record in this proceeding

According to the DOL, the parties have not been allowed to adequately examine the rates and the record is insufficient to support an across the board increase. The need for the increase is based solely on Verizon's assessment of Verizon's financial condition, he goes on, and raising rates due to financial concerns is contrary to the decision made by the Commission and Verizon to divorce earnings from rates. The DOL notes as well that the Staff proposal is nothing more than a vague concept upon which the parties cannot meaningfully comment. Rates should not be reset, according to a number of the parties, without undertaking a comprehensive review.[104]

A number of different challenges are raised to the proposed rate cap. Dr. Bronner agrees with the concept of a basic service price cap, but contends that the suggested price needs to be further justified.[105]

The CTANY contends that the $24.95 basic service rate could be reasonable in Manhattan, but there is no basis for assuming the rate would be just and reasonable elsewhere. Cablevision challenges the rate by pointing to the more recently filed $17/$22 Verizon rate for services that exceed those provided in a basic service offering. This suggests, The Cable Association claims, that the cost of providing basic service is considerably lower than the White Paper's $24.95, rendering the rate not reasonable.

The Assembly Standing Committee argues that if there is evidence of the need for rate increase, it should be presented on a record. It also notes that, from a statewide pricing perspective, rate groups are becoming increasingly anachronistic.

Cablevision and others also challenge the conclusion in the White Paper that Verizon's overall financial health has been substantially impacted by its loss of

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[104] The DOL charges that the rate increases proposed here are an improper shortcut around a formal rate proceeding.

[105] Dr. Bronner also suggests that multiple price caps could be appropriate.

access lines in New York. They say that the Verizon New York earned returns estimated in the White Paper (p. 38) are not reflective of Verizon's financial health. These parties point to the parent corporation's 2nd quarter of 2005 profit of $2.1 billion on revenues of $18.6 billion, suggesting that Verizon is doing quite well. Cablevision also points to Verizon Wireless, noting that it added 1.9 million new customers in the 2nd quarter of 2005 with an equal increase in the 3rd quarter, for a total increase in wireless customers of more than seven million in the last 12 months. These parties allege that the dismal view of Verizon's financial position is not supported by the financial results, and that there is no evidence of Frontier of Rochester's financial condition that would justify a rate increase.

The Joint CLECs support the argument that Verizon's loss of access lines in New York does not mean that it is suffering financially. According to the Joint CLECs, FCC data indicate that cable telephony's new subscriber sign-ups have slowed to a trickle. Thus, they conclude that Verizon's primary competitive threat in residential markets is Verizon itself. CWA opposes the increase in basic rates, calculating expected increases ranging from 58% to 190%. Such increases constitute rate shock, according to CWA, and it contends that the shock will fall disproportionately on those customers least able to afford it. CWA and CPB also suggest that the universal availability of affordable telephone service could be negatively impacted by such rate increases, an impact which the White Paper allegedly did not explore. CWA and CPB further argue that the White Paper failed to analyze the impact of the proposed price increases on consumers generally.[106] CWA requests a formal hearing at which a factual record could be developed.

CPB also challenges whether the $24.95 rate is just and reasonable today, pointing to the fact that it was a rate established in 2003. Assuming the rate was just and reasonable in 2003 in New York City, does not establish, according to CPB, that it is reasonable now in different locations with different characteristics.

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106 CPB also notes that no information of any kind was presented with regard to the recommended increase for Frontier of Rochester.

The CTANY argues that there is no rational basis for increasing basic rates and revenues for Verizon and Frontier while only allowing rural incumbents to raise basic rates on a revenue neutral basis. It also argues that deregulating Verizon and Frontier rates for all but one basic service, as recommended by the White Paper, is a violation of the Public Service Law. According to those comments, such an approach would not fulfill the statutory obligation that ratepayers be charged only just and reasonable rates for utility services. In particular, it contends that the Public Service Law (Sections 91, 92, and 97) prevents the Commission from allowing incumbent rates to float unconstrained with the market and that statutory tariffing and notice requirements cannot be waived in any event.

The Joint CLECs express their support for the uniform pricing of non-basic services arguing that without that requirement, non-competitive areas would not be provided the protection of market constrained pricing.

Frontier agrees with the assessment of a widespread competitive market for telecommunication services, but indicates that the White Paper falls well short of addressing that factual situation. Frontier argues that all incumbents should be granted true pricing flexibility, and that all non-basic services should be completely deregulated.

Frontier agrees with the recommended $24.95 basic service rate cap, but does not agree with limiting the revenue relief to just Frontier of Rochester and Verizon. Other Frontier affiliates are also facing the same challenges being experienced by Verizon and Frontier of Rochester, and there is no reason not to allow all incumbents the same level of pricing flexibility and revenue increases.

Frontier opposes the White Paper's recommendation for a uniform, service territory-wide rate for non-basic services. It is manifestly unfair, according to Frontier, to require uniform statewide prices for non-basic services without regard to the differing competitive circumstances faced by its affiliates.

The Rural Telephone Companies are concerned with the recommendation that incentives be provided for the acquisition of small telephone companies. They note that not all such companies desire to be sold, nor is there any evidence that the existing operations are not efficient or reliable. Unless clarified, it says, this recommendation may be inconsistent with the policy of the state to encourage the maintenance and growth of small businesses.

The Farm Bureau supports the $24.95 basic service rate cap but expresses concern about price spikes. It recommends that where basic service prices are to increase by more than 100%, the phase-in period should be no less than five years. It also urges that incentives for the acquisition of small telephone companies be provided only if it is established that such mergers will reduce costs to the consumer, increase choice, and improve reliability.

Verizon suggests that a number of modifications are required to Staff's pricing recommendations. It notes that backup power is not useful in fiber loops and suggests that a clarification of the definition of basic service is therefore required.

Verizon agrees with the $24.95 rate cap for statewide basic service, but disagrees with the recommendation that it be directed to design a rate transition plan. It views the basic service option set forth in the White Paper as an addition to all other basic service offerings and argues that it should have the flexibility to withdraw or amend the price or terms of the other basic services as market conditions and other considerations require. Under Verizon's approach no customer's rate would be increased immediately as all would be allowed to retain their existing basic service at their existing rate until new tariff leaves are filed and accepted. Verizon therefore concludes that a rate transition plan is not required.

Verizon also objects to the proposed territory-wide rate uniformity requirement for non-basic services. This proposal would limit Verizon's existing flexibility, it claims, which now allow rates to vary by geography. For example, it asserts that effective competition in Manhattan would not be possible if Verizon had to offer the same Manhattan-constrained prices in areas where the cost of servicing customers is higher than in New York City. Verizon also asks for a clarification regarding whether the pricing flexibility for non-basic services would be subject to price ceilings or limits on allowed annual percentage increases. Finally, Verizon argues that an anti-competitive price squeeze will not be effective in a competitive market. Therefore, it concludes that there is no need to impute a price floor for any non-basic service.

Discussion

We will discuss below our conclusions concerning the additional regulatory flexibility we are implementing for basic and non-basic service, but we first address those comments which characterized the White Paper's recommendations as the "deregulation" of the telephone utilities. This is not an accurate description of either the recommendation in the White Paper or of the actions we take here. We have previously granted the regulated carriers significant flexibility where that flexibility is required to allow the incumbents an opportunity to compete.[107] Clearly, market conditions have changed significantly since we last examined these issues,[108] and, based on these changes, we conclude that an incremental expansion of that flexibility be granted for Verizon and Frontier of Rochester. The changes we are adopting here represent measured, incremental changes in the regulatory framework which we have been successfully adjusting over the years to encourage the development of a competitive market. We are fulfilling our regulatory responsibility by relying more on competition and less on regulatory mandates, consistent with the Public Service Law.

Basic Service

The White Paper and many of the parties support the establishment of a single basic service priced at a uniform statewide rate under a rate cap. No party opposes the idea of having the incumbent carriers continuing to provide a basic service offering. Before turning to the disputed issues, we agree that incumbent carriers should continue to offer a basic service offering. The basic service offering will be provided at a regulated

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[107] PRP Order, supra; Case 29469, Proceeding on Motion of the Commission to Review Regulatory Policies for Segments of the Telecommunications Industry Subject to Competition, Opinion No. 89-12 (issued May 16, 1989)(Competition I); Case 94-C-0095, Proceeding on Motion of the Commission to Examine Issues Related to the Continuing Provision of Universal Service and to Develop a Regulatory Framework for the Transition to Competition in the Local Exchange Market, Opinion No. 96-13 (issued May 22, 1996)(Competition II); and 02-C-0959, Petition of Verizon New York, Inc., for Approval, Pursuant to Public Service Law §113(2) of a Proposed Allocation of a Tax Refund from the County of Nassau, Order Allocating Tax Refund (issued March 12, 2003).

[108] PRP Order, supra.

tariff rate and should ensure the continued universal availability of telephone service to New York's citizens.[109]

The White Paper focused its basic rate protections on ensuring that flat rate service would continue to be available at a rate no higher than an established statewide cap. To the extent the White Paper could be interpreted as allowing incumbents to eliminate existing message rate offerings in favor of a flat rate type service, we do not agree with the White Paper. Because we do not want to restrict customer choice, we believe it is essential to retain the message rate option. Thus, the message rate option, which is comprised of a fixed charge for an access line and a per call usage charge, will be deemed to be part of the basic service offering definition and is, therefore, a required offering for Verizon and Frontier of Rochester. This means that customers will continue to have two options to maintain a connection to the telephone network: a flat rate calling option and a message rate calling option.

As the White Paper acknowledges, the competitive market offers products and services often priced on a uniform basis throughout a territory, state, or region. However, Verizon's flat rate basic service rates in New York vary broadly depending on the customer's rate group. Rates also vary among the 40 incumbents in the state and between basic flat rate and basic message rate service. While these rate structures were appropriate in a monopoly environment, they may not be viable given the competitive intermodal market. For example, our forward-looking cost studies show that rural areas (where rates are low) are more expensive to serve than urban areas (where rates are higher).[110] Yet regulated rates have suppressed rural rates to levels below those in urban areas, thereby discouraging investment in the telephone infrastructure. We believe it imperative to change this rate structure to reflect the realities of the market and to better

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[109] We intend that the basic service offering protections we are adopting today will be available to customers taking basic service on a stand-alone basis or when they purchase basic service along with other services or features on an a la carte basis.

[110] Case 05-C-1303, supra, Order Denying Petitions Requesting Suspension of and Hearing on Tariff Filings, p. 7.

reflect the cost of providing service. To accomplish this purpose, we adopt the recommendation to allow the incumbents to file tariffs to provide for a basic service offering subject to the limitation described below. Existing rates differ and may continue to differ; incumbents will be allowed to charge any rate up to the limitation.

One aspect of the White Paper that drew considerable attention was the recommendation that Verizon and Frontier of Rochester be allowed to benefit financially from increasing their basic service rates, while requiring all other incumbents to make any desired basic service rate changes on a revenue neutral basis. Those opposing this approach also generally argue that there is no evidence of serious financial impacts on the incumbents from intermodal competition.

Our actions here are driven primarily by our recognition of the availability of real competitive alternatives and actual competitive gains that competitive carriers are achieving. These market forces are constraining incumbent prices and indeed are forcing incumbent prices down.[111] This, in turn, reduces financial margins on previously more profitable products and requires, for long-term viability purposes, that basic rates be adjusted to align more closely with underlying costs. These actions are supported by our view of market conditions and the relationship of basic rates to underlying costs. Our consideration of financial results tends to corroborate these primary findings, which demonstrate that the strength of competitive inroads is greatest in the Verizon and Frontier markets.

The White Paper reported that over the past five years (2000 thru 2004), Verizon New York lost almost 3 million access lines (about 25%), and Frontier Telephone of Rochester lost approximately 80 thousand access lines (about 16%). Over this period, Verizon's annual local service revenues declined by nearly $1 billion, and

[111] Based on a Bureau of Labor Statistics index of wireline telecommunications service provider prices, prices for telecommunications services have decreased at an average annual rate of 1.8% over the period 1996 to 2006 (http://data.bls.gov/cgi-bin/surveymost?pc).

Frontier's annual local service revenues declined by some $12.5 million.[112] As demonstrated below, these revenue losses have resulted in the companies' reported rates of return declining, and being much lower than what these companies would be allowed in a traditional rates case.

Verizon New York, Inc.
Intrastate Rate of Return and Return on Common Equity
Reported in PSC Annual Reports, Schedule 10

Year	Rate of Return	Return on Common Equity
2000	4.06%	-0.07%
2001	2.61%	-4.38%
2002	1.19%	-10.99%
2003	-6.30%	-40.26%
2004	-0.03%	-36.24%

Verizon New York has also seen a precipitous drop in its Moody's unsecured debt rating, falling a total of five levels, from Aa3 in 2002 to Baa2 (April 2004). During the same timeframe, the parent's (Verizon Communications, Inc.) corporate rating only fell one level, from A1 to A2. On December 21, 2005, Moody's dropped both by another level, Verizon New York down to Baa3 and Verizon Communications, Inc. to A3.[113]

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[112] We also note based on PSC Annual Reports that total company revenues for both Verizon New York, Inc. and Frontier of Rochester declined over the period from 2000 to 2004 consistent with their intrastate revenue declines. Some parties suggest that Verizon's wireline competitive losses in New York should only be considered in the context of profits made in other competitive lines of business and regulated profits made in other states by Verizon New York Inc.'s parent company. This would be a significant departure from the traditional approach of reviewing jurisdictional costs and associated revenues. See Brooks-Scanlon Co. v. Railroad Comm'n, 251 U.S. 396 (1920) and City of New York v. United States, 337 F. Supp. 150 (E.D.N.Y. 1972). Investors do not typically continue to support one project simply because another unrelated project is profitable. We decline to rely on non-jurisdictional earnings to offset jurisdictional losses.

[113] Standard and Poor's only uses a top-down approach. Verizon- NY's shares are thus rated the same as its parent – A (which was lowered from A+ on January 13, 2006).

Frontier Telephone of Rochester
Intrastate Rate of Return and Return on Common Equity
Reported in PSC Annual Reports, Schedule 10

Year	Rate of Return	Return on Common Equity
2000	8.25%	8.75%
2001	9.61%	11.02%
2002	10.47%	12.45%
2003	4.04%	1.73%
2004	4.13%	1.89%

Since being acquired by Citizens Communications in 2001, Frontier Telephone's debt rating has been that of its parent. That rating of Ba3 by Moody's has remained unchanged since the acquisition. Although Moody's affirmed Citizen's rating and upgraded its ratings outlook from negative to stable, it expects that competition will increase in the future, and given Citizens weak credit profile Moody's sees little flexibility for the company to develop new services or to respond to increased competition. We also note that Citizen's has been able to offset access line loss in large part through the sale of higher priced non-jurisdictional products such as DSL, and bundled products.[114]

The data also show that incumbent LECs other than Verizon and Frontier of Rochester have experienced smaller access line losses as a percentage of total access lines. This strongly suggests that the smaller incumbents may not have been as exposed to the new intermodal market to the extent Verizon and Frontier have and may not yet have experienced the level of financial losses experienced by Verizon and Frontier of Rochester. It is possible that some incumbents may be able to demonstrate a material competitive loss from competition.[115] Wherever that may be the case, a filing by the incumbent seeking additional pricing flexibility or additional revenues will be reviewed.

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[114] Under existing rules and regulations much of the revenue from these new product lines do not contribute to intrastate earnings, and are not available to offset state regulated revenue deficiencies.

[115] Several smaller incumbents have experienced large declines in access lines from 2000 to 2004 (e.g., Dunkirk and Fredonia lost 12%, Cassadaga and Ontario each lost 9%).

However, we have not been able in the context of this proceeding to examine the specific competitive circumstance of every incumbent, and, accordingly, we are limiting our grant of additional flexibility and additional revenues to Verizon and Frontier of Rochester.

It is our responsibility to balance interests in setting rates, and despite comments to the contrary, New York's wireline business is under substantial competitive financial pressure. It thus seems clear that the arrival of intermodal competition has affected the customer/investor balance to the detriment of the legacy carriers. The wireline losses cannot long continue before serious problems will arise in the maintenance and operation of the legacy infrastructure. Accordingly, we believe the appropriate balance in this instance is to permit Verizon and Frontier of Rochester to raise the monthly charge for the access line portion of message rate service. Similarly we will allow Verizon to gradually raise existing flat rate basic service rates up to a statewide cap rate, and to retain any additional revenues generated by the increases from both the message rate and flat rate services. (As we explain below, considerations of impact on customers leads us to a similar but more limited conclusion for Frontier.)

The pricing flexibility that we are authorizing will help ensure that high quality telephone services continue to be available, while also providing regulated carriers better incentives to maintain and upgrade their networks. Providing incumbent pricing flexibility to meet the market while protecting consumers with a regulated basic service also restores a more equitable balance between the interests of consumers and investors.

Message rate service is available throughout Verizon's and Frontier of Rochester's territories. A customer subscribing to message rate service pays a number of different rate elements on each monthly bill. For example, Verizon's message rate service consists of a fixed access line charge ($8.61), a per call usage component (approximately $5),[116] as well as a Federal Subscriber Line Charge ($6.39) for a total bill of approximately $20 per month, excluding taxes and mandated surcharges. Frontier's message rate service recovers even less revenue. Based on the cost studies we adopted in

[116] This assumes a customer makes approximately two local calls per day at 9¢ per call.

Case 98-C-1357,[117] we determined the total long-run incremental costs that an efficient provider utilizing the most efficient available network elements would incur in order to provide telephone services. These forward-looking costs were used to establish wholesale prices for unbundled network elements. While that standard is appropriate for providing competitors a needed input, it does not allow a company to recover its actual historic costs. Use of forward looking costs accordingly represents an aggressive (i.e., below actual historic levels) cost estimate, a fact we will recognize in balancing ratepayer and investor interests in this case.

As we described in Case 05-C-1303,[118] forward-looking costs for a basic offering, including forward-looking retailing costs, range from $22 downstate to $26 upstate. We recognize that these estimates of forward looking costs allow for more usage than the average message rate customer actually consumes.[119] But we also acknowledge that our forward looking costs were determined based on the most efficient telecommunications technology currently available and the lowest cost network configuration given the existing location of incumbent's wire centers.[120] Because of ongoing technological improvement (among other things), such forward looking estimates fall well below the costs the incumbents had actually historically incurred in constructing their network.[121] Thus, these costs do not always allow the incumbents to

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[117] Case 98-C-1357, Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements, Order on Unbundled Network Element Rates (issued January 28, 2002).

[118] Order Denying Petitions Requesting Suspension and Hearing on Tariff Filing (issued December 6, 2005).

[119] Approximately $5 of usage costs are included in the forward looking cost estimate, which is consistent with average usage for UNE-Platform customers. Forward looking usage costs for message rate customers, who do not use the phone as often, would be closer to $1.

[120] 47 CFR §51.505(b)(1).

[121] See, USTA v. FCC, 359 F.3d 554 (D.C. Circuit 2004).

recover the costs of the actual network that is being used to serve basic customers.[122] For these reasons, the use of forward looking costs to constrain prices is overly aggressive and rates above that level can still represent a fair balancing of customer and shareholder interests.

Those costs do, however, provide a critical indicator of the need to increase rates. Rates below identified forward looking costs are not only anti-competitive, but they suggest that rates are not even contributing to recovery of the costs of a hypothetical forward-looking network, let alone the one that actually exists. In this connection it is a concern that many rates (e.g., Verizon upstate and Frontier) are currently below those costs. In contrast, rates above forward looking costs present much less of a concern. In areas of the state where rates move above forward looking costs we expect that competitive pressures will act as a constraint.[123]

Accordingly, we believe it is reasonable to move rates to and above forward looking costs and will authorize an increase in the access line portion of the monthly message rate by $2 now and an additional $2 one year from now. These increases will give the companies (Verizon and Frontier of Rochester) the flexibility to align retail rates more closely with underlying costs. There is no basis to conclude that the usage component of the message rate service is not covering costs. Therefore, we will not authorize an increase in the usage component of the message rate offering.

Turning to flat rate service, a number of parties challenge the reasonableness of the $24.95 rate cap for basic service recommended in the White Paper and some have suggested that Verizon's recent offering of basic service plus three additional services ($17 downstate; $22 upstate) should be used as the basic service rate cap. First, we conclude that the $24.95 rate cap would be a just and reasonable rate cap for all the reasons described in the White Paper. It was competitively determined and had

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[122] The financial results noted above are based on historic plant costs. We recognize that competition may preclude pricing at some point above incremental cost and may compel continued underearnings by the incumbent carriers.

[123] For example, Verizon recently introduced its Regional Value Plan at $17 per month in the Metro LATA.

previously been found to be just and reasonable. Further, it is a rate cap and competitive pressures may well limit the price to a level well below $24.95.

In addition to being a competitively determined price, establishing a territory-wide basic service price supports our views on universal service. As noted above, rural rates have been lower than urban rates, despite rural service being more costly to provide, as demonstrated by TELRIC studies. Moving rural rates closer to their costs makes these customers more attractive to incumbents and enhances their ability to serve these customers. Allowing rural rates to increase to urban levels produces a more equal sharing of responsibility between urban and rural customers for high cost areas. Moving the rates to cost also encourages other intermodal competitors to enter the market and bring the benefits of competition more directly to rural customers.

Notwithstanding the above, we also agree with those contending that Verizon's recent tariff may also reflect a market determined price. Market prices change often, and the mere fact that they have no track record does not render them unreliable as a measure of the market price. We also note that AT&T Communications of New York, Inc. provides a basic local offering in New York. The offering has been provided relying on Verizon's wholesale Unbundled Network Element Platform (UNE-P) at forward looking Total Element Long Run Incremental Cost (TELRIC) prices. This competitive offering is analogous to basic service and has been available for $22.95, before surcharges. Our understanding is this offering is among the lowest price offered by competitive local exchange carriers in New York. Accordingly, we have different measures of market determined prices ($24.95, $22.95 and $22.00) and have decided to set the basic service offering rate cap between these prices at $23.00. This reflects both an established competitive price and a new competitive price and we therefore conclude that a $23.00 rate cap is just and reasonable. We decline to rely on the recently introduced $17 downstate price because that price does not reflect the cost characteristics that are more prevalent in most areas of the state.[124]

We therefore conclude that based on competitive offerings, cost, our interest in ensuring incumbent carriers are able to maintain a secure and reliable network, and our goal of maintaining universal service, a flat rate basic service offering with a statewide basic service rate cap of $23.00 is justified. We are required, however, to balance shareholder interests with customers' interests, and that balancing requires that we modify the recommendation in the White Paper. We depart from the White Paper's recommendation with respect to both the increase in the monthly charge and the three-year transition period.

We do not see a need for a three-year transition period because some rates are already close to $23 and others are well below costs. However, rather than a $5 increase in the charge, we believe a lower limitation of $2 is appropriate to moderate the increase. Verizon may increase its existing flat rate basic monthly service rates up to the $23.00 with annual increments limited to a $2 increase in the charge effective each year.[125]

Verizon will be allowed to retain the increase in revenues. We estimate that if the full basic rate increase were implemented by Verizon the revenue increases would be about 2.44% (1.25% in the first year). Balancing customer and shareholder interests, as required by the statute, leads us to conclude that the burden on customers is not so extreme that the company's shareholders should be denied the benefits of moving these rates closer to where they should, in theory, be.

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[124] Case 05-C-1303, supra, Order Denying Petitions Requesting Suspension of and Hearings on Tariff Filings (issued December 8, 2005). Unlike other parts of Verizon's territory, New York City has not had a long-standing flat rate offering. But the availability of the recently introduced Regional Value Plan at $17 per month in the MetroLATA satisfies our requirement to have a flat rate offering available at or below $23.

[125] We do not adopt Verizon's proposal to offer a new basic service offering that could supplant all existing basic service offerings. As we understand it, Verizon's proposal would add a new, regulated basic service offering and enable it to price existing basic service offerings flexibly.

A different result is warranted for Frontier because the increases that would be authorized produce more revenues as a proportion of overall revenues and would occur over a longer period of time and have a greater impact on customer bills because of Frontier's relatively lower rates. Even though the flat rate parameters we are establishing are justified, we will establish a two year check point for Frontier and require Frontier to demonstrate to the Commission's satisfaction that the competitive impacts and trends that we have identified are continuing and that there is a continuing financial need for the relief prior to implementing basic rate relief beyond year two. We will also consider customer rate impacts in that assessment. Thus, we will allow the basic rate increases for two years, at which time we will reconsider the balance of shareholder and customer interests and evaluate whether modification of our decision is warranted.

Finally, we require that any increases by the other independent incumbents be offset by access charge decreases, unless they can make individual showings to support a net revenue increase request.

We do not believe the basic rate increases we are authorizing will have an unreasonable impact on consumers or on our universal service goals. Customers taking Verizon's message rate may, if the full flexibility authorized is exercised, see a bill increase of approximately ten per cent per year over the next two years.[126] Further, Verizon's existing flat rate service for its Rate Group 9 costs $22.61 per month. Rate Group 9 is generally offered in more populous areas (Albany, Buffalo and Syracuse), and represents a significant portion of Verizon's flat rate customers. The substantially similar rate cap we impose today will enable customers to retain a basic connection to the public switched network, just as the Rate Group 9 price has. (In effect, customers in less densely populated areas will be paying rates that are comparable to those in more densely

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[126] Similarly, Frontier's current message rate service and flat rate services are priced substantially below Verizon's. Frontier's current message rate access charge is $4.53 (versus $8.61 for Verizon). Frontier's current flat rate service ranges from $6.23 to $11.71 (versus $15.81 to $22.61 for Verizon). Thus, if Frontier instituted the full increase for message rate in the first year, these customers would see their bills increase by approximately 14.0% while the average flat rate bill increase in the first year would be about 12.6% (versus 5.7% for Verizon flat rate customers).

populated areas[127].) The rate increases for those consumers who subscribe to basic flat-rate or basic message rate service will be in areas where current rates are not aligned with the cost to serve, a pricing structure that cannot be allowed to continue. Moreover, our required Lifeline service for low-income consumers should maintain affordability and further our goal of universal service. Finally, rates for customers who qualify for Lifeline shall not increase as a result of our actions in this Order.[128]

Raising rates toward costs in areas where rates are set well below costs will result in substantial long-run benefits to consumers. If wireline service is priced below forward-looking or actual costs (as it is in many rural areas), the ability of existing carriers to maintain and upgrade their plant to provide service is undermined and other carrier's ability to compete is seriously limited. This may well explain a few of the comments which noted less infrastructure development in rural areas. If rural rates more accurately reflect service costs, competitors may be able to extend their infrastructure and services to these areas. If nothing is done to adjust these subsidized rates, however, competition will be impeded and the benefits of intermodal services may be delayed or even denied in certain areas.

We disagree with those who argue that additional procedures and a more detailed review of the facts (including a formal evidentiary hearing) are required before any rate increases are granted. We are authorizing rate increases under section 97 of the Public Service Law, which does not require a formal, trial-type evidentiary hearing. The order initiating this proceeding provided notice to all parties concerning the broad objectives of the proceeding as well as the specific objectives, including retail pricing flexibility and allowing rates in less densely populated areas to increase to their

[127] Former toll pool members will, however, be eligible for assistance from the transition fund in instances where their basic rate would exceed the $23 statewide benchmark rate cap (or the appropriate rates as each rate cap is increased to that level).

[128] To ensure that rates to Lifeline customers do not increase, Lifeline rates will be frozen. Increases authorized for flat rate service will be effectuated via the access line portion of the rate and not the usage portion. Where Lifeline bills would increase as a result of the implementation of the basic rate flexibility authorized here, an offset modification to Lifeline rates shall be made to avoid increases to Lifeline rates.

underlying cost levels. All parties were given an opportunity to comment on these issues. Specific proposals to address the issues raised in the Commission's initiating order were then set forth in an extensive White Paper prepared by the Department of Public Service staff and all parties were afforded an opportunity to provide comments on those proposals. The process that we have followed has provided adequate notice and opportunity to comment on the issues that we are now addressing and we do not believe evidentiary hearings are necessary.

Verizon asks for a clarification regarding the basic service offering. It asks us to clarify the White Paper's definition of basic service, especially with regard to the requirement that it include "full backup power for the minimum hours consistent with what is currently required of the [incumbent] . . . ."[129] Verizon notes that backup power is not effective with fiber cable, and, accordingly, we will accept the White Paper's definition, except for the backup power requirement where the service is being provided over fiber.[130]

For incumbents other than Verizon and Frontier of Rochester, any increase in basic service rates consistent with the limitations described here shall be matched by a reduction of intrastate access charges (unless they make a showing that other treatment is warranted). Any increase must be applied uniformly for similarly situated customers consistent with existing rate groups.[131]

Non-Basic Services

The White Paper recommends that Verizon and Frontier of Rochester be provided full pricing flexibility for all non-basic service offerings,[132] subject to the requirement that the price established for each service be uniformly charged throughout

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[129] White Paper, p. 41.

[130] In these cases a battery back-up is used. Maintenance of the battery, however, is a consumer responsibility.

[131] We agree with Frontier that each of its affiliates should not be treated as a single territory. Our ruling in this Order addresses Frontier of Rochester. Each of the other Frontier affiliates will be handled as independent LECs and are subject to the same limitations as the independent telephone companies.

[132] We are referring here to non-basic, residential retail services only.

the utility's territory. Verizon and Frontier challenge the uniformity requirement and other parties argue that the flexibility we are granting is not justified by the market or is not permitted under the Public Service Law. Before proceeding to a discussion of these issues, a brief review of our long history in granting pricing flexibility in competitive circumstances will provide a context for the incremental actions we are taking here.

Beginning in 1970, we have granted substantial pricing flexibility to incumbent local exchange carriers for special services, Centrex, and custom calling features. Many custom calling features are now bundled into packages which offer discounts over individually priced features, and the company offers these packages in flexibly-priced ranges. Incumbents can also offer contracts targeted to meet any specific customer's unique needs through limited service offerings or on an individual case basis, without the need to seek prior approval (a tariff filing after the fact is still required). As a practical matter, individual case basis pricing is limited to non residential offerings and our grant of such rate flexibility has usually been conditioned on the availability of competitive options.

More recently, we synthesized our various policy determinations regarding pricing flexibility:

> The freedom to change rates rapidly to best reflect demand and costs is consistent with a competitive market. As the transition to competition continues, pricing flexibility must be accorded companies in competitive circumstances. Pricing flexibility, defined as the ability to change rates rapidly with the minimum of regulatory review, should be commensurate with the degree of competition. After careful review, we find that our existing pricing flexibility policies (a ceiling of no more than a 25% increase per annum, and a floor of relevant incremental costs) and individual case basis pricing (rates based on costs to an individual customer) are appropriate for dominant providers for competitive services during the transition period. [133]

Flexibility was also granted in 1996 when Public Service Law §92 was amended to exempt services other than "regulated basic services, switched carrier access

[133] Case 94-C-0095, supra, Opinion No. 96-13, p. 29.

services, charges for interconnections between local exchange carriers, and toll services" from publication and to reduce the notice requirements for those changes from 30 days to 10 days. Little review of these changes has been undertaken other than to ensure that any maximum limitation on rate increases is not violated because the services that may have prices changed on 10 days notice are non-basic and competitive.

Verizon's more recent pricing flexibility was established in its last rate settlement, the Verizon Incentive Plan (VIP). In that plan, Verizon was granted the ability to change virtually any retail rate up or down (but to a level no lower than incremental costs) as long as the net change did not produce a revenue increase in excess of 3% per year based on the prior year's volumes. Basic residential rates, however, were capped.

The Verizon VIP tariffs, which had been redesigned to facilitate the administration of retail pricing flexibility, reverted back to what they were before the plan when the VIP ended in 2003. Today, Verizon's pricing flexibility for retail non-basic services allows it to change rates by up to 25% per year. In addition, we have also long allowed Verizon's business exchange access service prices to vary between wire centers on a geographic basis. This authority only permits flexibility in wire centers that are deemed subject to competition and has not been exercised by carriers.

More recently, we have permitted Verizon to charge different prices for the same service in different areas when justified by cost differences. We found that:

> The Commission can distinguish between customers and can allow different prices based on demand elasticities of service in competitive situations, as long as the resulting differentiation is rational and not unduly discriminatory where justified by a balancing of shareholder and ratepayer interests.[134]

[134] Case 05-C-1303, supra, Order Denying Petitions Requesting Suspension of and Hearings on Tariff Filings, p. 8.

Accordingly, we allowed a $17 rate downstate and $22 rate upstate rate for the same service.[135]

In this proceeding, Verizon challenges the White Paper's non-basic service pricing recommendation, contending that the requirement to charge a uniform price for each service throughout its territory actually reduces its existing pricing flexibility. It also argues that imputing a rate floor to preclude predatory pricing is unnecessary because it could not benefit from predatory pricing in the existing market

Considering first the argument about price floors, we find that the cost of entry for intermodal competitors is less than the wireline LECs embedded costs and is falling. Further, given the uniform pricing rule for non–basic services and price cap for basic services that we are establishing, it would be virtually impossible for Verizon to price below its costs in competitive areas and to make up the difference by raising prices in non-competitive areas. Accordingly, we see no need to impute a specific price floor which would only serve to limit the incumbent's ability to compete and to limit the economic benefits consumers could enjoy. As always, we will continue to monitor price behavior to guard against pricing that is truly predatory or anticompetitive.

Concerning Verizon's second argument that the uniformity rule reduces existing pricing flexibility, the purpose of the White Paper's uniformity recommendation was to ensure that just and reasonable rates are maintained as rate flexibility is expanded, in particular to ensure that rates in areas with less competition are constrained by areas where competition is robust. This is a critical element in the White Paper's proposal to ensure the protection of the public, especially in areas where competition is less robust, and we are accordingly adopting this protection in principle. As a practical matter carriers do not use individual case basis pricing for mass market residential customers

[135] Id. Another basis we have long used to approve different rates for the same service in different areas is the number of local, non-toll phone numbers available to the customer. Rate groups have been based on this value-based approach where the service rate increases with the number of local phones that can be contacted.

and the actions we are taking do not affect existing flexibility for non-residential pricing. Further, our flexibility policies for residential services did not envision the authority to offer non uniform prices for areas with differing levels of competition, and we do not authorize discounts herein. Accordingly, our actions do not as a practical matter reduce existing pricing flexibility.

We also agree with the incumbents that different prices may be justified if cost or competitive differences between areas are significant. Our recent approval of Verizon's upstate and downstate Regional Value and Regional Essentials offerings is an example of such an approach. Therefore, we will require non-basic service rates to be uniform unless a rational basis to charge different rates in particular regions is established and approved by the Commission. The record that has been compiled in the proceeding thus far establishes that Verizon and Frontier of Rochester have sufficient competitive constraints territory-wide to constrain non-basic residential prices. Thus, where price changes pursuant to flexibly priced tariffs are implemented they must be implemented territory-wide. If carriers want to implement flexibility on a more disaggregated basis (i.e., upstate/downstate), they must first demonstrate that competition within the more disaggregated areas is sufficient to constrain prices in the aggregate.

With that safeguard we will allow Verizon and Frontier unlimited pricing flexibility for most non-basic services.[136] While the rates must still be tariffed pursuant to the Public Service Law, the competitive market and the pricing constraints it imposes eliminate the need to review in advance the reasonableness of non-basic service rates.

Finally, we are aware that there might be a few incidental services other than basic service that might not be sufficiently constrained by competition. These might

[136] Based upon our review of Verizon's current tariffs, we found that a number of Verizon's top non-basic products are not currently flexibly priced (although Verizon could have filed to incorporate such flexibility, subject to our review). Thus, our action today expands the class of non-basic services that we have determined have sufficient competitive alternatives to justify pricing flexibility. Further, our ruling with few exceptions, removes the maximum price for non-basic services. Non-basic prices will, however, be subject to the uniformity rule.

include for example, additional directory listings, non-published numbers, PIC changes, and restoral charges. We will not authorize flexible tariffs for these services, unless it can be demonstrated that competition is effective in constraining such service. Parties may also demonstrate that other non-basic services are also so incidental as to not be constrained by competition and should therefore not be permitted pricing flexibility.